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No. 98-613

IN THE

# *SUPREME COURT OF THE UNITED STATES*

**OCTOBER TERM 1998**

PEOPLES BANK & TRUST COMPANY OF HAZARD,
a Kentucky Banking Corporation

*Petitioner,*

v.

WILSON DAVID PENICK,
doing business as W. Penick Electrical Construction, Inc.

*Respondent.*

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

## BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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## QUESTION PRESENTED

**Is certiorari appropriate to hear Petitioner's argument that the circuits are split as to "who is a fiduciary" for purposes of 11 U.S.C. §523(a)(4) when all circuits inquire into their respective state law to determine if the required express or technical trust exists and the apparent differences between the circuits exist only because of variations of state law?**

## TABLE OF CONTENTS


Page

Question Presented . . . . . i

Table of Contents . . . . . ii

Table of Authorities . . . . . iii

Statement of the Case . . . . . 1

Arguments of Law . . . . . 3

Reasons for Denying the Writ of Certiorari . . 3

Determination of Fiduciary Under Code §523(a)(4) . . . . . 3

The Apparent Split Among Circuits as to "Who is a Fiduciary" . . . . . 6

Kentucky's Common Law Fails to Create an Express or Technical Trust . . . . . 8

Conclusion . . . . . 10

## TABLE OF AUTHORITIES


Aero Drapery of Kentucky v. Engdahl,
507 S.W.2d 166 (Ky. App. 1974) 5, 8, 9

Merrywell v. Barwick (In re Barwick),
24 B.R. 702 (Bkrtcy. Va. 1982) 4

Carlisle Cashway, Inc. v. Johnson (In re Johnson),
691 F.2d 249 (6th Cir. 1982) 2, 3, 5, 7-10

Central Hanover Bank v. Herbst,
93 F.2d 510 (2nd. Cir. 1937) 4

Chapman v. Forsyth,
43 U.S. 202, 11 L.Ed. 236 (1844) 3, 4

Davis v. Aetna Acceptance Corp.,
293 U.S. 328, 55 S.Ct. 151,
79 L.Ed. 393 (1934) 4, 5

Energy Products Engineering, Inc. v. Reuscher
(In re Reuscher),
169 B.R. 398 (Bkrtcy. Ill. 1994) 7

Capitol Indemnity Corp. v. Interstate Agency, Inc.
(In re Interstate Agency, Inc.),
760 F.2d 121 (6th Cir.1985) 8

Kapila v. Talmo (In re Talmo),
175 B.R. 775 (Bkrtcy. Fla. 1994) 5

In re Lewis,
94 B.R. 406 (Bkrtcy. Va. 1988) 4

In re Marchiando,
13 F.3d 111 (7th Cir. 1994), *cert. Denied sub nom.,* Illinois Dep't of Lottery v. Marchiando, 512 U.S. 1205, 114 S.Ct. 2675, 129 L.Ed.2d 810 (1994) 6

Rider v. The John G. Delker & Sons Co.,
140 S.W.2d 1011 (Ky. 1911) 5, 8, 9

**STATUTES**

KRS 271B.6-400 2

11 U.S.C. §523(a)(4) 2-7, 9, 10

## STATEMENT OF THE CASE

From 1980 to 1995 Wilson David Penick ("Penick") owned and operated a business known as W. Penick Electrical Construction, Inc. ("Penick Electrical") as its sole officer and director throughout eastern Kentucky. Penick Electrical was not incorporated but Penick had always conducted business under this corporate name, filed corporate tax returns, kept separate corporate journals, records and bank statements and believed that the corporate status existed.

Penick Electrical had borrowed approximately one-half million dollars from Peoples Bank & Trust Company of Hazard, Kentucky, ("Peoples Bank"). On June 17, 1993, Penick Electrical consolidated all of its business debt into one note in the amount of $410,536.69, and Penick executed it as a co-maker.

During the operation of Penick Electrical, Penick borrowed approximately $520,000 from his business for investment in, and to remodel, the Grand Hotel in Hazard, Kentucky. Penick reported the loans on its corporate tax returns, listed them on the corporate journals and classified them as such on its corporate account receivables. After the remodeling was completed in 1993, however, the hotel could only be sold for less than the first mortgage.

In early 1995, Penick Electrical ceased operations, and on March 20, 1995, Penick filed an individual Chapter 7 bankruptcy seeking a discharge of his personal obligations, including his personal loans from Penick Electrical and Peoples Bank, at which time Peoples Bank was owed $317,820.60.

Peoples Bank filed a "Complaint to Discharge-ability of Indebtedness" on November 17, 1995 alleging

that Penick "committed a defalcation of Penick Electrical's assets [under KRS 271B.6-400] while acting in a [corporate] fiduciary capacity within the meaning of 11 U.S.C. §523(a)(4)." Upon motions for summary judgment, the United States Bankruptcy Court entered an order dismissing Peoples Bank's Complaint because it failed to prove the existence of all *prima facie* elements of a nondischargeable debt under Code §523(a)(4) requiring the existence of an express or technical trust pursuant to Carlisle Cashway, Inc. v. Johnson (In re Johnson), 691 F.2d 249 (6th Cir. 1982).

The United States District Court reversed its lower court reasoning that Kentucky's common law established a "trust relationship" between officers of an insolvent corporation and its creditors.

The United States Court of Appeals for the Sixth Circuit reversed the District Court after analyzing the two Kentucky common law cases by finding that they failed to satisfy the fiduciary capacity element, reasoning that a "fiduciary" requires the existence of an express or technical trust.[1]

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[1] Petitioner has conceded that Kentucky's corporate statutes do not create an express or technical trust.

## ARGUMENTS OF LAW

### Reasons for Denying the Writ of Certiorari

Three reasons exist why Peoples Bank's Petition should be denied. First, the Sixth Circuit properly inquired into state law to determine whether the requisite trust relationship existed to satisfy the "fiduciary capacity" element under Code §523(a)(4). Second, the apparent split among the circuits as to "who is a fiduciary" under the federal statute exists only because of variations in state laws. Third, the Sixth Circuit properly held that the common law of Kentucky failed to establish the requisite trust relationship as defined in Johnson, *supra*.

### Determination of Fiduciary Under Code §523(a)(4)

The United States Supreme Court in Chapman v. Forsyth, 43 U.S. 202, 11 L.Ed. 236 (1844), in construing a predecessor provision of Code §523(a)(4), held that a debtor who violated the terms of a contract and failed to turn over the proceeds from the sale of a creditor's goods to the creditor was not a "fiduciary" for purposes of the nondischargeability provision, explaining that the agreement contained no language purporting to create a "trust." It was in this context that the Supreme Court held that the Code applied only to express or technical trusts and not to implied trusts:

> The cases enumerated, the "defalcation of a public officer," "executor," "administrator," "guardian," or "trustee," are not cases of implied but special trusts, and the "other fiduciary capacity" mentioned, must mean

> the same class of trusts. The act speaks of technical trusts, and not those which the law implied from the contract. Id. 43 U.S. at 208.

Since Chapman, *supra*, the Supreme Court has consistently applied this standard for over 150 years.

This Supreme Court further explained that "[i]n almost all commercial transactions of the country, confidence is reposed in the punctuality and integrity of the debtor, and a violation of these is, in a commercial sense, a disregard of a trust. But this is not the relation spoken of in the first section of the [§523(a)(4)] act." Chapman, *supra*, at p. 207.

In 1934, this Supreme Court further narrowed the scope of the term "fiduciary" in Davis v. Aetna Acceptance Corp., 293 U.S. 328, 55 S.Ct. 151, 79 L.Ed. 393 (1934), by holding that even if a written agreement used "trust" language and imposed some trust-like duties upon the debtor, it would still not necessarily create the requisite fiduciary relationship under the federal bankruptcy definition to declare a debt nondischargeable.[2] Since the turn of this century, it is clear that the Supreme Court has narrowly defined the term "fiduciary" under a defalcation claim so as to require the "fiduciary capacity"

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[2] See In re Lewis, 94 B.R. 406 (Bkrtcy. Va. 1988), pointing out that most business transactions are based upon some form of "trust" to perform, but to elevate such trust to a fiduciary relationship would deny debtors a discharge of most of their debts. See, also, Central Hanover Bank v. Herbst, 93 F.2d 510 (2nd. Cir. 1937); Merrywell v. Barwick (In re Barwick), 24 B.R. 702 (Bkrtcy. Va. 1982).

element to arise from an express or technical trust.

Since the term "fiduciary" under Code §523(a)(4) requires the existence of a trust relationship, all circuits have employed this holding to define "who is a fiduciary" for purposes of Code §523(a)(4) by inquiring not only into federal law but also into state law to determine if such a relationship can be imposed by state statute or common law. See Davis and Johnson, *supra*, and In re Talmo, 175 B.R. 775 (Bkrtcy. Fla. 1994).

In the present case the Sixth Circuit held that Peoples Bank must show that there was a fiduciary relationship between Penick and his business creditor, i.e., Peoples Bank, and that this relationship created an express or technical trust that placed a specific trust *res* in the hands of the debtor. The Sixth Circuit inquired into Kentucky's common law to determine if an express or technical trust existed for such officers and found in the negative.

To determine if such a trust relationship existed, the Sixth Circuit compared Rider v. The John G. Delker & Sons Co., 140 S.W.2d 1011 (Ky. 1911), and Aero Drapery of Kentucky, Inc. v. Engdahl, 507 S.W.2d 166 (Ky. App. 1974) (the only two Kentucky cases that impose personal liability for corporate officers' misappropriation) with the federal definition of a "fiduciary." The Sixth Circuit analyzed the common law of Kentucky to find that a trust was not specifically created.[3]

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[3] The Sixth Circuit opined that these two Kentucky cases did not create a trust because: (1) the trust *res* was not clearly defined; (2) they did not unambiguously create a trust; and (3) the trust did not impose specific affirmative duties for officers to protect the corporate assets, as discussed *infra*.

Because the Sixth Circuit inquired into state law for its reasoning, then it properly followed the precedent of this Supreme Court, and there is no compelling reason to change that procedure. Petitioner's Writ of Certiorari should be denied on that basis alone.

**The Apparent Split Among Circuits as to "Who is a Fiduciary"**

Petitioner cites a Seventh Circuit decision in In re Marchiando, 13 F.3d 111 (7th Cir. 1994), *cert. denied sub nom.*, Illinois Dep't of Lottery v. Marchiando, 512 U.S. 1205, 114 S.Ct. 2675, 129 L.Ed.2d 810 (1994), to show that the circuits are split as to "who is a fiduciary" for purposes of Code §523(a)(4). Marchiando, *supra*, stands for the proposition that assets of an insolvent corporation constituted the trust *res* placed in the hands of the debtor for the benefit of the corporation's creditors. This case, however, turned on the interpretation of Illinois corporate statutes and their case law, not common law.

Petitioner, however, did not cite any case from Kentucky or any other jurisdiction, including the Second and Seventh Circuits, where a court interpreted a state's common law to satisfy the "fiduciary capacity" element relating to officers of an insolvent corporation under the federal bankruptcy definition. No case could be cited because Petitioner's authority is based solely upon states' statutory construction of corporate law rather than common law. In other words, all circuits that have affirmed nondischargeable defalcation actions turned their decisions on the interpretation of the statute of the state where the federal court was sitting.

Kentucky has no corresponding corporate statute or decision that makes or even infers an officer to be a

"fiduciary" of an express or technical trust. The Sixth Circuit noted that the Seventh Circuit "has implied that the fiduciary relationships between, . . . directors and their corporation, would satisfy the 'fiduciary capacity' requirement of section 523(a)(4) because the fiduciary obligations pre-exist the debt caused by the breach of that duty." (See Petition's Appendix B, at A-10, fn. 1). However, Illinois statutes have clearly defined a trust *res* and imposed specific affirmative duties for officers to guard the *res*, and Illinois case law has interpreted an officer's breach of those duties to be a violation of a trust relationship. The Sixth Circuit was not persuaded by that circuit's reasoning because Kentucky's statutes and case law do not remotely parallel Illinois'.

Illinois corporate statutes and case law provide that officers and their corporate creditors form an express fiduciary relationship sufficient to meet the federal standard under Code §523(a)(4), like the Michigan statute that imposes specific duties for contractors to account for money received for the benefit of subcontractors in Johnson, *supra*.

Although Petitioner argues that numerous courts have held that a technical trust could include relationships in which "trust-type" obligations are imposed by common law, citing Johnson, *supra*, with approval, however, Petitioner simply cannot provide any authority from any jurisdiction where the common law was actually held to create such a relationship for officers of an insolvent corporation to its creditors.

Petitioner offered the opinion in Energy Products Engineering, Inc. v. Reuscher (In re Reuscher), 169 B.R. 398 (Bkrtcy. Ill. 1994) as an example of the "common law trust principle," but as discussed above, that case turned on Illinois corporate law, not common law. Although

Petitioner's contention that common law could, in theory, satisfy the definition of a "fiduciary" under bankruptcy law, no court in any jurisdiction has so held. In fact, the courts that have affirmed nondischargeability actions have based their decisions only upon statutory construction.

Ultimately the apparent split among the circuits as to "who is a fiduciary" rests with the interpretation of state law. Since the Sixth Circuit inquired into Kentucky's common law and found that officers of insolvent corporations do not satisfy the federal bankruptcy definition of "fiduciary," then the Sixth Circuit properly followed the precedent of this Supreme Court by interpreting state law. Due to the variations of corporate statutes throughout the states, there is no compelling reason for this Supreme Court to accept Petitioner's Writ.

**Kentucky Common Law Fails to Create an Express or Technical Trust**

After the Sixth Circuit inquired into the common law of Kentucky, it analyzed the fiduciary duties imposed on corporate officers. It found that Aero Drapery and Rider, *supra*, did not *clearly define a trust* or *impose specific affirmative duties* for officers of insolvent corporations. The Sixth Circuit opined that:

> These [Kentucky] cases may recognize that a corporation has [general] fiduciary duties to its creditors, but they fall far short of creating the type of clearly defined trusts that existed in [and was required by] In re Johnson, 691 F.2d at 252-253, and in In re Interstate Agency, Inc., 760 F.2d at 124-125. The mere recognition that an insolvent corporation or one of its directors owes a fiduciary

> obligation to the corporation's creditor's [sic] does not create an actual trust fund, as is required by §523(a)(4). (See Petitioner's Appendix B, at A-12).

In Johnson, *supra,* the Sixth Circuit held that a trust must satisfy a three prong test before a defalcation claim may be sustained: (1) the trust *res* must be clearly defined by either statute or common law; (2) the statute or common law must unambiguously create a trust; and (3) the trust must impose specific affirmative duties for officers to protect the trust's assets. Since Aero Drapery and Rider, *supra*, did not contain any language to satisfy the three prong test, Kentucky's common law failed to create the requisite trust relationship as defined under federal bankruptcy law.

Aero Drapery and Rider, *supra*, only stand for the basic proposition that directors and officers of an insolvent corporation can incur personal liability for their malfeasance by allowing a creditor to pierce the corporate veil. The fact that Penick borrowed money from his business while it was insolvent, in essence, means that a creditor may pierce the corporate veil to hold him personally liable for his loans or, allegedly, improper withdrawals. That is why Penick included Peoples Bank as a creditor on his personal bankruptcy petition to seek a discharge.[4]

Peoples Bank's Complaint was, therefore, properly dismissed because proof of an express or technical trust

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[4] The Aero Drapery and Rider courts interpreted Kentucky's common law to create nothing more than the means to a remedy for aggrieved creditors, or an avenue to "pierce the corporate veil" by imposing personal liability for officer's malfeasance, and nothing more.

was absent under Kentucky law, and for this third reason alone, there is no compelling reason to grant certiorari.

## CONCLUSION

The Petitioner's Writ of Certiorari should be denied because: (1) the Sixth Circuit inquired into state law to determine if the requisite trust relationship existed to satisfy the "fiduciary capacity" element under 11 U.S.C. §523(a)(4); (2) there is no split among circuits as to "who is a fiduciary" because all circuits inquire into state law, even though state law varies throughout the country; and (3) the two Kentucky cases cited by Petitioner fail to satisfy the three prong test outlined by Johnson, *supra*. This case, therefore, does not merit further review.

Respectfully submitted,

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